Existing Home Sales

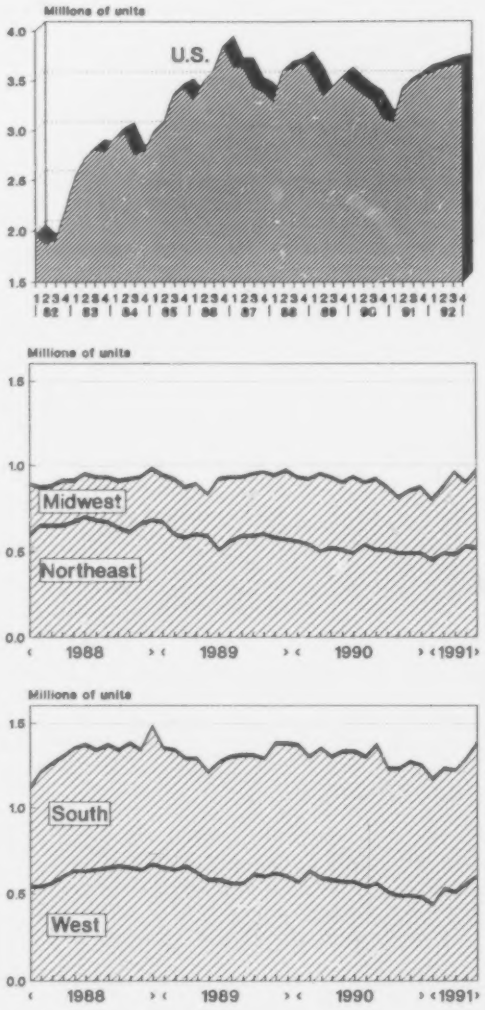
National Data

		Mo. Ago % Chg.	Yr. Ago % Chg.
May 1990	3,350	-0.6	3.1
Jun 1990	3,370	0.6	3.1
Jul 1990	3,320	-1.5	1.2
Aug 1990	3,410	2.7	-1.8
Sep 1990	3,160	-7.3	-0.9
Oct 1990	3,070	-2.8	-10.0
Nov 1990	3,150	2.6	-12.0
Dec 1990	3,130	-0.6	-11.5
Jan 1991	2,900	-7.3	-12.1
Feb 1991	3,160	9.0	-16.4
Mar 1991	3,220	1.9	-7.6
Apr 1991	3,310	2.8	-6.4
May 1991	***3,510***	***6.0***	***-1.8***
Annual Averages:			
1989	3,440		-4.3
1990	3,296		-4.2

Regional Data

	Northeast	Midwest	South	West
May 1990	520	910	1,340	580
Dec 1990	500	880	1,260	490
Jan 1991	460	810	1,180	450
Feb 1991	500	880	1,240	540
Mar 1991	490	970	1,230	520
Apr 1991	540	910	1,300	570
May 1991	***530***	***980***	***1,390***	***610***
Annual Averages:				
1989	589	919	1,307	610
1990	522	892	1,325	557
Percent changes in May 1991 since:				
May 1990	1.9	7.7	3.7	5.2
Apr 1991	-1.9	7.7	6.9	7.0

Levels are seasonally adjusted annual rates, in thousands.
Source: National Association of Realtors, 'Home Sales'



Sales of existing homes continued to build momentum in May, rising 6.0% to an annual rate of 3.51 million units. May's figure represents the fourth consecutive increase in the rate of existing home sales and is the highest level since December of 1989. While continued growth should be interpreted as a sign of the incipient recovery, it should also be viewed with some caution. The pent-up demand which gathered during the recession and the Persian Gulf Crisis may have fueled this rebound over the last few months. In all likelihood, these current levels will not be matched over the next few months.

The Northeast was the only region that did not post a gain in resales during May. In spite of this decline, sales remain 1.5% above the average for 1990. The gain was distributed evenly among the remaining three regions. In the Midwest, sales of existing homes displayed the greatest strength, increasing 7.7% from April's 910,000-unit rate. Sales of existing homes increased 7.0% in the West to a rate of 610,000 units. Similarly, the South saw an increase of 6.9%, rising to 1.39 million units.

Existing home sales are expected to post a 10.6% gain over the first quarter's rate. This increase reflects the strong advances made in April and May of this year. Thereafter, sales will continue to grow at a healthy clip, reaching an annual rate of 3.56 million units by the fourth quarter of 1991. The momentum established in 1991 will position the resale market for robust growth in 1992. Sales of existing homes are projected to increase 7.2% in 1992. In 1993, the pace of sales will experience a slight deceleration, increasing 2.3%.

Prices of New & Existing Homes

National Data

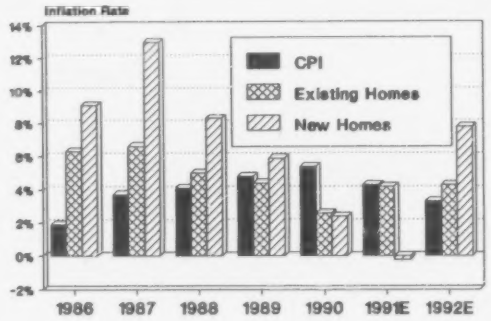
	Median		Average	
	Existing	New	Existing	New
May 1990	95,200	125,000	118,500	150,600
Dec 1990	91,700	127,000	114,100	153,400
Jan 1991	95,600	117,900	123,000	148,600
Feb 1991	94,000	119,900	119,700	147,800
Mar 1991	98,200	122,900	125,200	157,400
Apr 1991	100,300	120,000	128,900	149,400
May 1991	***99,700***	***121,900***	***127,500***	***154,400***
Annual Averages:				
1989	93,100	120,400	118,100	148,300
1990	95,500	122,300	118,600	149,100
Percent changes in May 1991 since:				
May 1990	4.7	-2.5	7.6	2.5
Apr 1991	-0.6	1.6	-1.1	3.3

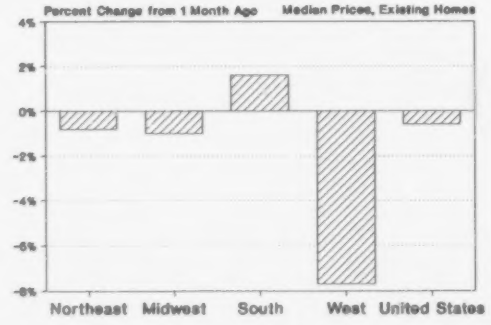
Regional Data

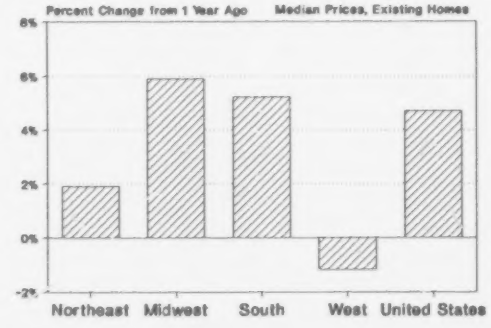
Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
May 1990	140,900	72,800	85,000	141,800
Dec 1990	134,400	72,300	82,800	131,400
Jan 1991	136,900	74,500	84,600	149,600
Feb 1991	137,200	76,400	83,200	137,100
Mar 1991	142,700	78,200	87,300	147,300
Apr 1991	144,800	77,900	88,000	151,800
May 1991	***143,600***	***77,100***	***89,400***	***140,100***
Annual Averages:				
1989	145,200	71,300	84,500	139,900
1990	141,200	74,000	85,900	139,600
Percent changes in May 1991 since:				
May 1990	1.9	5.9	5.2	-1.2
Apr 1991	-0.8	-1.0	1.6	-7.7

Levels are shown in dollars.
Source: National Association of Realtors, 'Home Sales'







The national median price of existing single-family homes dipped below the $100,000 level in May. The month's 0.6% decrease pushed the price down to $99,700. May's decline is indicative of the greater quantity of homes purchased in the lower price ranges by entry-level buyers. In the market for new homes, the median price increased 1.6% to $121,900 in May. This increase put the median price of a new home 2.5% below the figure of a year ago.

The average price of an existing home decreased by 1.1% in May to $127,500. Since May of 1990, the average price has risen 7.6%. An increase of 3.3% in May resulted in a gain of $5,000 to the average price of a new single-family home.

Modest appreciation in the median price of an existing single-family home is expected over the current year. For the year, the median price is expected to increase 4.2%, holding prices below the $100,000 mark. Thereafter, the median price of an existing family home will continue to appreciate and should increase 4.3% and 4.5% in 1992 and 1993, respectively. The median price of a new single-family home is expected to retreat in 1991, decreasing 0.2% to $122,000. By 1992, the median price of a new single-family home is projected to appreciate with renewed force, increasing 7.8% to $131,500.

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The Credit Crunch: Real Estate in Danger

From an NAR Staff Briefing Paper

Through a combination of regulatory stringency, a changing financial industry and economic recession, the decline in investment real estate values that infected the Southwest has spread through the country. In some markets, optimism bred from the economic expansion of the Eighties led to overbuilding. But in many more markets, the *ex post* changes in tax rules contained in the Tax Reform Act of 1986 inflicted punitive damages on the real estate industry and ruined ongoing projects. And in even more markets, financial institution regulators drove banks away from real estate credit and starved a great many projects. These changes occured against the backdrop of an anit-inflation campaign staged by the Federal Reserve which limited the ability of banks to make loans.

All of this resulted in the current credit crunch. As depicted in the chart to the right, the growth in lending by commercial banks for real estate-related assets has been severely crimped since the late 1980s. The plunge in growth has been particularly sharp since early 1990.

In the spring of 1991, the Real Estate Finance Division of the NATIONAL ASSOCIATION OF REALTORS® prepared a briefing paper on the impact of the credit crunch on real estate. This article is adapted from that study. Its chief findings include:

- The credit crunch is real. Developer surveys suggest that nearly 95 percent of the respondents have felt the tightening of credit in the past year.
- The real estate industry is a vital cog in the nation's economic machine. Currently the sector accounts for close to a sixth of GNP and employs in excess of 4 million people.
- The Tax Reform Act of 1986 devastated real estate values. Restoration of the pre-1986 treatment of capital gains, passive losses and depreciation lives would increase investment real estate values by 12 to 18 percent.

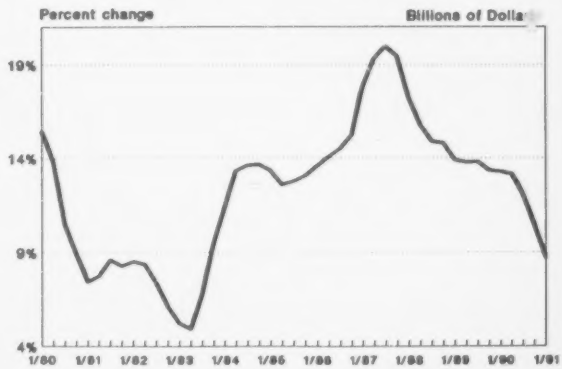
This article focuses on the credit crunch as it affects real estate. After an overview of the credit crunch, we'll briefly discuss the results of two surveys conducted by NAR to measure the depth of the credit crunch. Finally, the changes made in the tax system, an important source of instability in real estate over the past decade, will be discussed.

Overview of the Credit Crunch

The term "credit crunch" describes the increase in difficulty that creditworthy borrowers have ex-

Real Estate Loans

Made by Commercial Banks



Source: Federal Reserve, *Loans & Securities at All Commercial Banks*

perienced in receiving credit from lending institutions. First felt in the spring of 1990, the current credit crunch resulted in large part from the reluctance of banks to make loans on real-estate related assets. This reluctance had many sources: the increased scrutiny by regulators after the S&L debacle, the failure of real estate properties to appreciate as they had in the Eighties, and slower growth in the economy.

As loan losses mounted, portfolio values deteriorated and regulatory pressure intensified, banks found themselves in weak financial condition. Loan standards were tightened, and borrowers who were previously able to obtain credit found themselves squeezed out of the credit market.

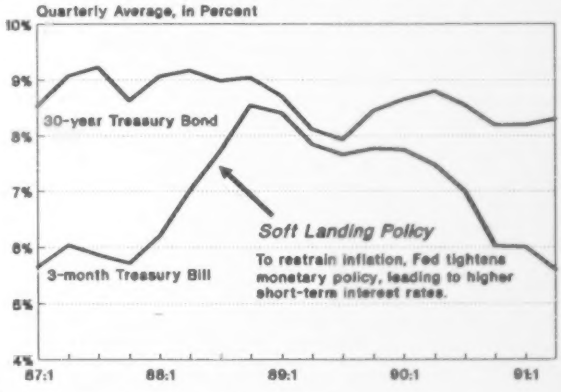
While it's clear that lending activity was falling, it's less clear just what the precise cause is. Increased regulatory pressure would lower the supply of credit, but, on the other hand, the nation's recession would limit demand for credit. If the recession is playing a large role, then the credit crunch is really a product of reduced demand, not restricted supply, and therefore a result of normal market forces which would dissipate when the recession ended. Yet it could be argued that a cutoff in the supply of credit is itself one of the major causes of the recession. The available evidence shows that both supply and demand have reinforced each other in lowering lending activity.

One gauge of changes in lending restrictions is the Federal Reserve's periodic surveys of top lending officers at banks across the country. In November 1990, half of the banks surveyed said they had imposed stiffer terms on business loans in the prior six weeks. In the January 1991, one-third of those surveyed had tightened restrictions in the previous six weeks. By May, the credit crunch seemed to be easing somewhat as only 15 percent of those surveyed had tightened credit.

While restrictions on real estate were srticter than on loans for other business activities, the three surveys show that fewer banks were increasing their requirements for real estate development and construction loans. In the November survey, about two-thirds of the respondents had tightened restrictions for the real estate industry, but by January that figure fell to half, and by May it had fallen to one-quarter of the respondents. Commenting on the surveys before the Senate Finance Committee, Fed Chariman Alan Greenspan suggested that the credit crunch, while not easing, was perhaps reaching its peak.

The Soft Landing

Short- and Long-Term Interest Rates



Source: Federal Reserve, *Selected Interest Rates*

Federal Reserve Credit Policy

The banks' growing reluctance to extend credit to real estate projects wasn't the only genesis of the credit crunch. Even if real estate had been particularly favored, the banks would have found a decreased ability to make any type of loan. This was due to the Federal Reserve's inflation-fighting policy, which limited the growth of credit in the economy.

In attempting to achieve effective price stability, the Fed took aim at lowering the 4 percent rate of inflation that had been prevailing since the early 1980s. Fiscal policy was already highly stimulative (that is, large and persistent federal budget deficits were generating extra demand in the economy), and so the Fed hoped that a well-announced and credible campaign to lower inflation would be effective without pushing the economy into recession. By putting upward pressure on short-term interest rates in 1988, the Fed pursued a "soft landing" policy that would slow the economy but also bring a lower rate of inflation. As the chart shows, short-term rates climbed over two percentage points while long-term rates held steady.

The Fed's actions can be seen more directly when looking at banking reserves, the primary channel by which the Fed supplies new credit to the market. Banks are required to keep a percentage of their deposits at the Federal Reserve in non-interest bearing accounts. Since these funds provide no return to the banks, banks have a strong incentive to minimize these reserves. When the Fed supplies more reserves to the

system, banks are able to take the excess, lend it out and consequently make a return. When the Fed drains supplies from the banking system, banks need to send new funds to cover their reserve requirement, leaving less for lending.

With this in mind, note the growth pattern depicted in the accompanying chart showing year-over-year changes in banking reserves. In both 1979 and 1989 -- each a year before a recession and a credit crunch -- reserve growth was negative. In 1988, to put upward pressure on short-term interest rates and thereby institute its soft landing policy, the Fed squeezed reserve growth to 1.8 percent from 14.1percent a year earlier. This was followed in 1989 by a 0.7 percent *decline* in the level of reserves. Clearly, the Fed's attempt to wring inflation from the economy is one major source of the credit crunch.

As mentioned earlier, the Fed's policy limited lending throughout the economy, not just in real estate. But real estate was particularly susceptible due to the problems brought on by overbuilding and, in particular, changes in tax laws. The effects of these changes will be discussed later in this article.

Survey Evidence of Problems in Real Estate Markets

NAR conducted two national surveys to determine the extent of the credit crunch. The first survey was conducted in early October, 1990. NAR mailed approximately 16,100 Commercial Credit Condition surveys to ask if commercial financing credit conditions had changed in local market areas over the last six months. The individuals surveyed were primarily commercial real estate brokers and commercial developers. Recipients of the questionnaire included all members of the Society of Office and Industrial REALTORS (SIOR), the Commercial and Investment Real Estate Institute (CIREI) and nearly 8,000 members of the Urban Land Institute (ULI). The survey had a 10 percent response rate, with 1,636 questionnaires returned to NAR.

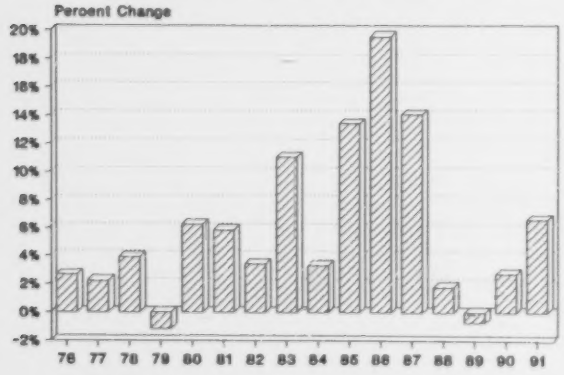
The follow-up survey was conducted in early January, 1991. NAR mailed approximately 14,000 Commercial Credit Condition surveys to all members of SIOR, CIREI, and nearly 5,000 members of ULI. Surveyed individuals were asked about commercial financing credit conditions in their market area over the last six months, with an emphasis on roll-over and permanent acquisition financing for income-producing property. The response rate was slightly higher for the second survey as 12 percent, or 1,612 questionnaires, were returned to NAR.

October survey respondents were asked eleven questions about credit conditions in their market. January survey respondents were asked twelve questions about rollover and permanent financing conditions in their market. A number of salient points can be extracted from these surveys. They include:

- Credit conditions are perceived to have tightened significantly in all regions of the country. More than nine out of ten respondents indicated that their local market had been negatively affected during the last six months. This tightening has been manifested both in a lack of available credit and unfavorable credit conditions.
- Respondents indicated that the regulatory environment was the principal reason for the change in credit conditions, although weak financial institutions and poor market conditions were also mentioned as contributing factors.
- Most survey respondents indicated that they were attempting to make other arrangements for financing as a result of problems with their current lenders. More than three-quarters of respondents indicated that they were searching for alternative financing, while less than 40 percent indicated success in their efforts.
- Comments from respondents in the Midwest (the triangle of states between Ohio, Kansas and North

Growth in Banking Reserves

Credit Crunches Follow '79 and '89 Declines



Source: Federal Reserve, *Aggregate Reserves.*
Data for 1991 is the annualized rate of the first half's growth.

Dakota) indicated that they had healthy local markets, but that national regulatory pressure was causing local lenders to be overly conservative.

- Office properties were the most widely reported property type experiencing difficulty in acquiring financing, followed by retail properties. In spite of having the highest current returns of all commercial property types, softening in retail markets and consumer pessimism is causing lender caution. Clearly the office market is experiencing difficulty because it is the most overbuilt property type in the majority of market areas.

- For those seeking alternative sources of financing, October respondents seeking permanent financing reported more success for their efforts than did those seeking development or construction financing.

- October survey respondents reported that the S&Ls' role as a market lender had already declined in 1989 and was declining further in 1990. Commercial banks were the primary source of commercial financing in 1990, although they were less active than in 1989. Non-traditional sources of financing -- sellers, private investors, and assumptions -- increased their roles in 1990.

- Over half (53 percent) of the January respondents who attempted to rollover a loan in the previous six months (just over half of all respondents) had difficulty in obtaining that financing. The Northeast (Pennsylvania and above) recorded the greatest proportion of respondents reporting such problems, at 68 percent; the Midwest had the smallest proportion reporting difficulty, at 45 percent.

- Of those January respondents who reported difficulty in obtaining rollover financing, 46 percent indicated that they had a performing loan with a bullet and were unable to rollover the loan with their lender. Thirty-three percent cited difficulty in obtaining permanent financing when having a performing construction loan. Twenty-four percent of these respondents indicated that they had an existing performing loan which was called by their lender.

- Retail properties received the highest share (41 percent) of difficulty in obtaining rollover financing in the January survey. Office properties followed at 34 percent, industrial properties were next at 26 percent, and multifamily properties were mentioned by 24 percent of the respondents.

- A lack of available financing or unfavorable credit terms offered to creditworthy borrowers caused difficulties in selling property for 71 percent of the January respondents. Financing was the most difficult in the South (from Maryland down through Texas) and Northeast and was less difficult in the Midwest, where 60 percent of the respondents reported difficulty.

- Over two-thirds of the January respondents experiencing difficulty in selling property due to financing conditions reported that a creditworthy borrower was unable to obtain permanent financing on income-producing property. Sixty-two percent reported difficulty due to unfavorable financing terms and conditions.

- October survey respondents overwhelming reported that market credit conditions would either decline or remain the same over the next year. Fifty percent of the respondents indicated that credit conditions would worsen in the next twelve months, and only 10 percent indicated that their local market would improve over the next year. The remaining 40 percent believed that conditions would remain the same.

- The picture brightened somewhat in January's survey. Forty-one percent of all January respondents indicated that they expected credit conditions to decline over the next twelve months while 32 percent expected improvement. The remaining 27 percent believed credit conditions would remain the same over the next twelve months. Southern respondents were the most optimistic; Northeastern respondents were the most pessimistic.

The Impact of Destabilizing Tax Policy Changes Over the Past Decade

Among major consumer budget categories, housing is the second largest expenditure item, accounting for roughly one-sixth of total U.S. consumption expenditure. In terms of federal tax policy, housing is the most heavily targeted consumption expenditure of all major budget categories. A major reason tax policy has focused to such an extent on housing is that housing expenditure variations have had a major impact on business cycles both in precipitating recessions and in leading the economy out of recessions.

Over the last ten years, the real estate sector of the U.S. economy has been buffeted by a series of major tax policy changes including, the 1981 Economic Recovery Tax Act (ERTA), the 1984 and 1985 Tax

Reform Acts and the 1986 Tax Reform Act (TRA). The most significant tax reforms have been ERTA and TRA.

Passed during one of the most severe postwar recessions, ERTA was designed to stimulate the economy. The act is perhaps best known for reducing the top marginal income tax rate from 70 to 50 percent. For taxpayers in the highest tax bracket, the cut in the top tax rate reduced the benefit of itemized deductions such as the popular homeowner deductions for mortgage interest and property taxes.

However, ERTA also included provisions directly targeted to boost the housing sector of the economy. In addition to reducing the top marginal income tax rate, the act reduced the marginal tax rate on long-term capital gains for the highest-income investors from 28 percent to 20 percent, and shortened the tax lifetime for residential rental property from 32 to 15 years.

As a result, investment in housing and commercial real estate development increased significantly in many markets between 1981 and 1984. In fact, ERTA was so successful in boosting the real estate sector of the economy that Congress increased the tax lifetime for real property to 18 years in 1984 and to 19 years in 1985.

TRA Replaces Tax Incentives with Disincentives

In 1986, the impact of the 1984 and 1985 tax acts was dwarfed by TRA, which completely reversed most of the economic recovery provisions enacted in 1981 as part of ERTA. TRA eliminated the distinction between capital gains and other types of income and raised the top marginal tax rate to 33 percent. Moreover, TRA extended the tax lifetime for residential properties to 27.5 years and for commercial properties to 31.5 years. The Act also required straight-line depreciation rather than the faster 175 percent declining balance method.

Passive Loss Restrictions Discriminate Against Real Estate Investments

On top of these conventional changes, the passive activity loss provision contained in TRA created a new category of income called passive income. Under this provision, income is deemed passive if it is derived from the conduct of a trade or business and the taxpayer does not materially participate in the activity. This provision especially discriminates against real estate. With minor exceptions, all income from rental real estate activities is considered "passive," regardless of the level of the investor's participation in the activity that generates the income. Losses from passive activities such as rental real estate, to the extent they exceed income from such activities, generally may not be deducted from other income, such as salary and portfolio income. Some taxpayers, however, may be eligible to offset up to $25,000 of nonpassive income annually by net losses and credits from rental real estate activity. To qualify, the taxpayer must actively participate in the rental real estate activity. The $25,000 amount is reduced by 50 percent of the amount by which a taxpayer's annual adjusted gross income (AGI) exceeds $100,000. Thus at an AGI of $150,000, the exemption disappears.

For taxpayers who have used up their respective allowance or who have AGIs in excess of $150,000, passive losses may only be used to offset passive income. In cases where passive losses exceed passive income, the excess losses are suspended and carried forward to offset passive income that might arise in subsequent years and, to the extent not used, are allowed to offset other income in the year a taxpayer disposes of his interest in the activity. Although investors in passive activities are permitted to offset passive losses eventually, they may have to sustain such losses for many years. During this period they are denied any earnings from money tied up in the suspended losses.

In addition, the limitation on passive losses also raises the after-tax risk of rental projects, since it provides limited loss-offset in unprofitable projects. The higher risk associated with rental projects is translated immediately into higher capitalization rates for rental real estate projects. Moreover, the loss limitations also discourage high-leverage rental projects because the interest deductions in these projects are no longer as valuable to their investors.

Disincentives Contained in TRA Cause Abrupt Drop in Property Values

Almost overnight, the present values of most real estate projects plummeted when TRA was enacted. The results of standard cash flow analysis shown in Table I reveal how the present value of a typical residential rental property, operating before TRA, would have dropped more than 20 percent after TRA was enacted.

Case 1 in Simulation One shown in the table indicates that a residential rental property generating an average net income for such a property and subject to typical financial assumptions would have had a present value of $7,447,345 and an after-tax internal

Table I:
Tax Policy Changes and Property Values

Incremental Effects of Selected Provisions of the 1986 Tax Reform Act on the Value of a Residential Rental Property

Assumptions:

Price	$7,447,345	Capitalization Rate	8.7%
Land Value as a Percent of Price	15.0%	Initial Annual Operating Costs	$665,855
Furniture and Fixtures as a Percent of Price	5.0%	Initial Annual Rents	$1,313,774
Structures as a Percent of Price	80.0%	Growth Rate of Operating Costs	4.0%
Downpayment as a Percent of Price	10.0%	Growth Rate of Rents	4.0%
Interest Rate	10.0%	Inflation	4.0%

Case	Cumulative Changes to Pre-1986 Tax Law	Before-Tax Internal Rate of Return (IRR)	Projected After-Tax Internal Rate of Return (A/T IRR)	PVof Property Required to Yield A/T IRR Under Pre-1986 Tax Law	Cumulative Change in PVof Property Required to Yield A/T IRR Under Pre-1986 Tax Law
	Simulation One: Passive Loss Limits Applied Before Depreciation Rule Changed				
1	No Change	19.2%	33.1%	$7,447,345	0.00%
2	28% Top Income Tax Rate	19.2%	23.8%	$6,567,345	-11.82%
3	28% Top Capital Gains Tax Rate	19.2%	22.7%	$6,487,345	-12.89%
4	Passive Loss Limits Apply	19.2%	16.2%	$5,944,000	-20.19%
5	Depreciation Under 1986 Rule	19.2%	16.2%	$5,930,000	-20.37%
	Simulation Two: Depreciation Rule Changed Before Passive Loss Limits Applied				
1	No Change	19.2%	33.1%	$7,447,345	0.00%
2	28% Top Income Tax Rate	19.2%	23.8%	$6,567,345	-11.82%
3	28% Top Capital Gains Tax Rate	19.2%	22.7%	$6,487,345	-12.89%
4	Depreciation Under 1986 Rule	19.2%	18.9%	$6,037,345	-18.93%
5	Passive Loss Limits Apply	19.2%	16.2%	$5,930,000	-20.37%

Notes: PV - present value; simulation results derived using planEASe Economic Analysis System.

rate of return (A/T IRR) of 33.1 percent before TRA. Because the A/T IRR is determined in the capital markets (and is therefore a given in the analysis), the before-tax IRR and the value of the property are the only two variables that could change in response to TRA. Since rents are assumed to be held in check by a large inventory of existing buildings, only the price of the property can change in the short run. Thus, because TRA causes the projected A/T IRR to fall given the existing property value and rent, the value of the property after TRA has to drop 20.37 percent to $5,930,000 in order to maintain an unchanged A/T IRR of 33.1 percent.

Because many tax provisions were enacted simultaneously with TRA and since the effect of each of these provisions is interdependent with each of the other provisions, it is difficult to assess the precise effect of individual provisions on the present value of the property. Comparison of Simulation One and Simulation Two shows that the measured effect of passive loss limits and 1986 depreciation rules depends on the order in which it is assumed such provisions are enacted.

In Simulation One, it is assumed that TRA is implemented one provision at a time beginning with a cut in the marginal income tax rate, then an increase in the capital gains rate, then application of passive loss limits and finally a change in depreciation rules. The reduction in marginal income tax rates by itself reduces the property's present value by 11.82 percent. Dropping marginal income tax rates and raising the top capital gains tax rate cause a 12.89 percent decline in present value. Applying passive loss limits in addition to all of the previous changes would reduce the property's present value by 20.19 percent, assuming that all passive losses must be carried forward to be offset against future passive income. As the final case shows, adopting all of the above tax changes plus the 1986 depreciation rule results in a 20.37 percent decline in the property's present value. From these results, it appears that the passive loss limits account for 7.3 percentage points (20.19% - 12.89%) of the 20.37 percent decline, or more than one third of the total decline.

Rearranging the order in which the tax provisions are implemented, however, significantly alters the apparent effect of each provision on the property's present value. For example, in Simulation Two, the 1986 depreciation rule is assumed to be adopted before the passive loss limits are applied. Under this assumption, the depreciation rule accounts for 6.04 percentage points (18.93%-12.89%) of the 20.37 percent decline, representing slightly less than a third of the total decline.

The substantial changes in the effects of both the passive loss limitations and the 1986 depreciation rule on the property's present value caused by the order in which each provision is implemented show that each effect is closely related to both provisions. In other words, the benefit of more rapid depreciation is smaller to the extent that passive losses can only be used to offset passive gains, since passive losses resulting from faster depreciation must be deferred; and the benefit of being allowed to offset ordinary income with passive losses is smaller to the extent that depreciation benefits are reduced, since more rapid depreciation, in many cases, is a major source of passive losses.

Although rearranging the order in which the tax provisions of TRA are implemented alters the apparent effect of each provision, the 20.37 percent total decline in the property's present value remains unaffected. This predicted decline in the property's present value however, requires that all passive losses are carried forward. The total decline would be slightly less to the extent that an individual is not fully constrained by the passive loss limits, either because he meets the qualifications required to be able to offset up to $25,000 of passive losses against active income, or because he has sufficient net passive gains from other activities. However, most individuals undertaking an investment of this magnitude, on average, are likely to be fully constrained by the passive loss limitations.

Tax Policy Changes Affect Real Estate First, Then Savings and Loans

After nearly five years of priming the real estate pump, Congress suddenly reversed course in 1986, abruptly choking the industry. While it was conceded, at the time that real estate investors would suffer losses as a result of TRA at first, it was argued that such losses would be at least partially offset by rising rents because the new tax laws would discourage new construction which, in turn, would force up rents of existing buildings. As it turns out, however, the supply of existing buildings has been sufficient to keep downward pressures on rents for many years.

With the rules changed virtually overnight and with only limited provisions included to apply the new tax laws gradually so as to allow investors to adjust, investors suddenly found themselves having to swallow 15 to 20 percent declines in the values of their real estate portfolios. Reductions in project values of this magnitude were sufficient to push many marginal

Table II:
Tax Policy Changes and Property Values

Incremental Effects of Selected Tax Policy Changes on the Value of a Residential Rental Property

Assumptions:

Price	$7,447,345	Capitalization Rate	8.7%
Land Value as a Percent of Price	15.0%	Initial Annual Operating Costs	$665,855
Furniture and Fixtures as a Percent of Price	5.0%	Initial Annual Rents	$1,313,774
Structures as a Percent of Price	80.0%	Growth Rate of Operating Costs	4.0%
Downpayment as a Percent of Price	10.0%	Growth Rate of Rents	4.0%
Interest Rate	10.0%	Inflation	4.0%

Case	Cumulative Changes to 1990 Tax Law & Basic Assumptions	Before-Tax Internal Rate of Return (IRR)	Projected After-Tax Internal Rate of Return (A/T IRR)	PVof Property Required to Yield A/T IRR Under 1990 Tax Law	Cumulative Change in PVof Property Required to Yield A/T IRR Under 1990 Tax Law
	Simulation One: 28% Marginal Income Tax Rate				
1	No Change	19.2%	16.2%	$7,447,345	0.00%
2	Passive Loss Restrictions Removed	19.2%	18.9%	$7,760,000	4.20%
3	20% Top Capital Gains Tax Rate	19.2%	20.0%	$7,906,000	6.16%
4	Pre-1986 Depreciation Rule	19.2%	23.8%	$8,250,000	10.78%
5	Capitilization Rate Falls to 8.2%	19.2%	24.3%	$8,330,000	11.85%
	Simulation Two: 32% Marginal Income Tax Rate				
1	No Change	19.2%	16.2%	$7,447,345	0.00%
2	Passive Loss Restrictions Removed	19.2%	19.3%	$7,810,030	4.87%
3	20% Top Capital Gains Tax Rate	19.2%	20.6%	$7,980,000	7.15%
4	Pre-1986 Depreciation Rule	19.2%	25.2%	$8,410,000	12.93%
5	Capitilization Rate Falls to 8.2%	19.2%	26.5%	$8,610,000	15.60%
	Simulation Three: 34% Marginal Income Tax Rate				
1	No Change	19.2%	16.2%	$7,447,345	0.00%
2	Passive Loss Restrictions Removed	19.2%	18.8%	$7,830,000	5.14%
3	20% Top Capital Gains Tax Rate	19.2%	20.9%	$8,120,000	9.03%
4	Pre-1986 Depreciation Rule	19.2%	26.0%	$8,570,000	15.10%
5	Capitilization Rate Falls to 8.2%	19.2%	27.3%	$8,800,000	18.20%

Notes: PV - present value; simulation results derived using planEASe Economic Analysis System.

projects into insolvency. Since, according to most sources, mortgages and mortgage-backed securities account for almost 86 percent of all savings and loan assets, the significant increase in real estate investment failures in turn reduced the solvency of many marginally solvent savings and loans. Thus, where Congress originally sought to bring the economy out of recession by boosting the housing sector, it eventually contributed to the current decline in the economy by hitting the housing sector abruptly with costly tax changes that significantly lowered asset values which, in turn, substantially exasperated an existing tightness in credit markets.

Potential Changes in the 1986 Act to Ameliorate Current Market Problems

Reversing the Trend in Real Estate Prices

One of the basic underlying causes of the current credit crunch is the perception, justified or not, that real estate under current market conditions in many regions represents an inferior investment opportunity. The downward trend of real estate prices in many markets that had experienced sustained and rapid price appreciation has reduced expectations with respect to the future earning potential of real estate investments. In time, the market will eventually adjust to the radical changes in tax policy brought about by the Tax Reform Act of 1986 (TRA), resulting in a reduced supply of housing and commercial buildings and higher rents. Given the severity of the shock to the industry caused by TRA, however, the adjustment period could be relatively long, causing persistent harm both to the banking sector and to the economy in general.

One policy option that could reduce this adjustment period would be to mitigate the severity of certain provisions of TRA. As shown in the preceding simulations, the provisions that have particularly hurt the real estate industry include those pertaining to the treatment of passive activity income, capital gains and depreciation rules. Table II reveals the cumulative impact of modifying these provisions on the value of the same typical residential rental property assumed in the previous simulations.

Simulation Results of Potential Tax Policy Changes

Three simulations are included to show the impact of each provision under different assumptions regarding an investor's marginal income tax rate. The 1990 tax act maintains the 28 percent tax bracket and establishes a new maximum tax bracket of 31 percent beginning at a taxable income of $49,300 for a single return and $82,150 for a joint return for 1991. In addition to establishing a higher maximum rate, the act also imposes a reduction in the non-exempt itemized deductions in the amount of 3 percent of adjusted gross income (AGI) over $100,000 for single filers and married couples filing jointly. The reduction in non-exempt itemized deductions adds an additional 1 percentage point to the maximum marginal income tax rate for taxpayers with AGIs above $100,000. Thus the top marginal tax rate for some taxpayers is 32 percent.

The 1990 tax act also adds approximately 0.5 percent to a taxpayer's marginal tax rate for each personal exemption claimed if the taxpayer's AGI exceeds $150,000. As a result, a married couple with two children and AGI in excess of $150,000 could have a marginal tax rate of 34 percent. It is likely that the marginal investor in commercial real estate has a marginal income tax rate nearer 34 percent than 28 percent. To consider several possibilities, the marginal income tax rate is assumed to be 28 percent in Simulation One, 32 percent in Simulation Two, and 34 percent in Simulation Three.

If passive loss restrictions are removed, as assumed in case 2, the increase in the projected A/T IRR ranges from 2.7 percentage points in Simulation One to 3.3 percentage points in Simulation Three. The change in the value of the property required to leave the actual A/T IRR unchanged ranges from 4.2 percent in Simulation I to 5.14 percent in Simulation Three.

Case 3 assumes Case 2's removal of passive loss restrictions and lowers the top capital gains tax rate to the pre-TRA rate of 20 percent. The resulting value of the property would have to increase by at least 6.16 percent in Simulation One and by as much as 9.03 percent in Simulation Three to leave the respective A/T IRRs unchanged.

Case 4 combines these tax policy changes with a return to the pre-1986 depreciation rules, which results in a cash flow that would require at least a 10.78 percent increase in the property's value in Simulation One and a 15.10 percent increase in Simulation Three to yield the respective actual A/T IRRs.

The Impact of Tax Reform on Capitalization Rates

If the passive loss restrictions are removed, investors in real property of this nature, which typically

yields substantial losses until it is sold, will be more certain that they will be able to bear such sustained losses until a profit can be realized since they will be able to offset such losses against income from non-passive activity. Investors will no longer have to speculate whether they will be able to generate sufficient passive gains to offset passive losses as they occur. This reduction in uncertainty would reduce the riskiness of such an investment, which would result in a lower capitalization rate since a significant component of the capitalization rate is a risk premium.

The lower capitalization rate, in turn, would result in a higher property value given that property value is equal to the flow of income net of expenses discounted by the capitalization rate. Case 5 shows that the increase in value of this property could range from 11.85 percent in Simulation One to 18.20 percent in Simulation Three if in conjunction with all of the above tax policy changes, the capitalization rate were to fall from its current rate of 8.7 percent to 8.2 percent.

Shortening the Adjustment Period with Tax Policy Changes

Cash flow analysis shows that changes in tax policy could increase the value of real property substantially. Rising real estate values, in turn, could increase the willingness of lenders to underwrite real estate projects. The improved tax environment coupled with easier access to credit could substantially reduce the adjustment period required for the real estate sector to recover from the effects of TRA

Federal Government Responses to the Credit Crunch

Belatedly, the Administration has recognized the existence of the credit crunch. The most substantive response to the credit crunch from the Administration is the regulators' joint supervisory policies announcement. The four federal banking and thrift institutions regulators' plan proposes guidelines clarifying specific regulatory and accounting principles intended to "contribute to a climate in which banks and thrifts will make loans to creditworthy borrowers and work constructively with borrowers experiencing financial difficulties...." Specific points central to the joint agencies' plan are recognition of income for certain non-performing loans; valuation of real estate loans in examinations; and guidance on issues relating to nonaccrual assets and formally restructured debt. The regulators expressed concerns that the "availability of credit to sound borrowers" should not be "adversely affected by supervisory policies of depository institutions misunderstanding about them."

This article is adapted from an NAR Staff Study: **The Impacts of Tax Policy and Regulation on Real Estate and Financial Institution Soundness.** *(April 1991). Principal contributors to the study were:*

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The study was edited for the Real Estate Outlook by Robert Barr.

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U.S. Economic Outlook: July 1991

	90.4	91.1	91.2	91.3	91.4	92.1	92.2	92.3	1989	1990	1991	1992	1993
U.S. Economy													
Annual Growth Rate													
Real GNP	-1.6	-2.8	0.7	2.4	2.5	3.0	3.7	3.2	2.5	1.0	-0.2	2.8	2.9
Industrial Production	-7.2	-9.8	0.5	1.4	4.5	4.1	6.3	6.1	2.6	1.0	-2.6	4.4	5.4
Civilian Employment	-0.9	-2.4	0.0	2.4	1.4	1.2	1.4	1.7	2.0	0.5	-0.5	1.4	1.4
GNP Inflation Index	2.8	5.2	4.2	3.5	3.1	3.3	2.7	3.0	4.1	4.1	4.0	3.1	2.9
Consumer Prices	7.0	3.5	2.2	3.7	3.4	3.2	3.2	3.9	4.8	5.4	4.3	3.3	3.5
Value of the U.S. Dollar	-19.0	8.0	46.5	11.9	3.8	1.7	0.7	-0.1	6.2	-9.6	3.9	5.0	-1.0
Percent													
Mfg. Capacity Utilization	80.8	78.0	77.5	77.4	78.0	78.6	79.6	80.6	84.0	82.3	77.8	80.1	83.4
Civilian Unemployment	5.9	6.5	6.8	6.8	6.8	6.8	6.7	6.5	5.3	5.5	6.7	6.6	6.1
Percent of GNP													
Federal Tax Receipts	20.4	20.4	20.4	20.4	20.5	20.7	20.7	20.7	20.2	20.3	20.4	20.7	20.7
Federal Expenditures	23.7	22.7	23.0	23.7	24.0	24.1	23.9	23.6	22.8	23.3	23.3	23.8	23.3
Federal Budget Deficit	-3.3	-2.3	-2.6	-3.2	-3.4	-3.5	-3.2	-3.0	-2.6	-3.0	-2.9	-3.1	-2.6
Interest Rates, Percent													
Federal Funds Rate	7.7	6.4	5.8	5.8	6.1	6.2	6.4	6.5	9.2	8.1	6.0	6.4	6.5
3-Month T-Bill Rate	7.0	6.0	5.6	5.6	5.8	6.0	6.1	6.2	8.1	7.5	5.8	6.1	7.8
Prime Rate	10.0	9.2	8.7	8.5	8.5	8.5	8.5	8.5	10.9	10.0	8.7	8.5	8.5
Discount Rate	6.9	6.2	5.7	5.5	5.5	5.7	5.9	5.9	6.9	7.0	5.7	5.9	6.1
Corporate AAA Bond Yield	9.3	8.9	8.9	9.1	8.9	8.7	8.6	8.6	9.3	9.3	9.0	8.6	8.4
30-Year Government Bond Yield	8.5	8.2	8.3	8.2	8.1	8.0	7.9	7.9	8.4	8.6	8.2	7.9	7.8
Mortgage Rates, Percent													
30-Year Fixed Rate	10.0	9.5	9.5	9.3	9.2	9.2	9.1	9.0	10.3	10.1	9.4	9.1	8.9
1-Year Adjustable	8.1	7.6	7.3	7.2	7.1	7.0	7.0	7.0	9.3	8.4	7.3	7.0	7.0
Home Sales & Starts													
Thousands													
Total Single-Family Sales*	3,879	3,798	4,222	4,308	4,393	4,449	4,526	4,600	4,413	4,164	4,180	4,548	4,702
Existing Single-Family Sales	3,117	3,093	3,420	3,487	3,558	3,587	3,626	3,654	3,440	3,296	3,389	3,633	3,717
New Single-Family Sales	470	464	483	502	543	563	588	602	650	534	498	592	632
Housing Starts	1,042	915	990	1,044	1,091	1,119	1,192	1,265	1,376	1,193	1,010	1,215	1,341
Single-Family Units	786	726	827	847	862	889	928	976	1,003	895	815	944	1,015
Multi-Family Units	256	189	163	197	229	231	264	289	373	298	195	271	325
2-4 Family Units	31	31	33	40	46	45	50	54	55	38	38	51	54
5+ Family Units	225	158	130	157	183	186	214	236	318	260	157	220	271
Mobile Homes Shipped	178	161	171	189	194	205	217	221	199	188	179	215	232
Percent change -- Year Ago													
Total Single-Family Sales	-13.8	-15.2	-0.2	4.4	13.3	17.1	7.2	6.8	-4.4	-5.9	0.0	8.8	3.4
Existing Single-Family Sales	-11.9	-10.2	1.7	5.8	14.2	15.9	6.0	4.8	-3.6	-4.7	2.8	7.2	2.3
New Single-Family Sales	-27.9	-22.3	-10.4	-4.1	15.5	21.2	21.7	19.8	-3.3	-18.5	-6.7	18.8	6.8
Housing Starts	-22.9	-36.1	-17.8	-7.7	4.7	22.3	20.4	21.2	-7.5	-13.3	-15.3	20.3	10.4
Single-Family Units	-20.9	-31.8	-7.7	-1.1	9.6	22.4	12.2	15.2	-7.3	-10.8	-8.9	15.7	7.6
Multi-Family Units	-28.4	-48.7	-47.1	-28.2	-10.4	21.9	61.9	46.8	-8.0	-20.1	-34.7	39.2	20.1
2-4 Family Units	-42.2	-27.1	-24.8	26.2	46.0	43.7	53.8	32.5	-5.8	-32.1	0.1	34.9	7.5
5+ Family Units	-26.0	-51.5	-50.7	-35.4	-18.5	17.6	64.0	50.5	-8.3	-18.0	-39.7	40.2	23.0
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	92.2	95.9	99.7	100.1	101.0	102.0	103.0	103.9	93.1	95.5	99.2	103.4	108.1
New Home Prices	122.0	120.2	120.9	121.6	125.2	128.8	130.8	132.4	120.0	122.9	122.0	131.5	138.9
Percent Change - Year Ago													
Existing Home Prices	-0.5	0.5	3.2	3.6	9.5	6.3	3.3	3.8	4.4	2.6	4.2	4.3	4.5
New Home Prices	-2.0	-2.9	-4.5	4.2	2.6	7.1	8.2	8.9	5.9	2.4	-0.2	7.8	5.6

Quarterly figures are seasonally adjusted annual rates.

* Total single-family sales equals single-family resales plus 97% of single-family housing starts.

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Robert Barr and Kimberly Martin.

The *Real Estate Outlook* features a monthly summary of the current condition of the U.S. economy, easy-to-read forecasts for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets.

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Real Estate OUTLOOK

August 1991

While the recovery may be underway, recent economic statistics suggest the economic locomotive is not steaming ahead. Job growth was negative in July, and orders for durable goods fell sharply in June. While the economic fundamentals still remain weak, several factors nevertheless continue to suggest recovery. Businesses are expanding production in order to restock inventories, and long-term interest rates are expected to fall a bit further as upbeat inflation reports continue to roll in. Taken together, these factors suggest that the recovery will be able to motor along and avoid the much-discussed double-dip. *Page 2*

Housing starts increased for the third consecutive month in June. An increase of 5.2% brought the annual rate of housing starts to 1.040 million units. The average for the second quarter of 1991 is 9.5% above the first quarter's figure. Accounting for much of the increase was a surprising 29.8% increase in housing starts in the Northeast. *Page 4*

The rate of existing home sales continued its ascent in June. An increase of 1.4% put the rate of existing home sales at its highest level since January of 1989. The momentum established in the first half of 1991 is expected to position the resale market for stable growth over the forecast period. *Page 6*

Also In This Issue:

These Meddlesome Priests	*Economic Commentary by John A. Tuccillo*	*Page 1*
Outlook for the Economy & Real Estate	*Robert D. Barr & Kimberly A. Martin*	*Pages 2-7*
Historical Data Tables		*Pages 8-14*

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These Meddlesome Priests

by John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

Last month, President Bush reappointed Alan Greenspan to the Chair of the Federal Reserve Board. While the timing was uncertain, the issue was never in doubt. The Chair has the power to affect crucially the life of the nation, and the ability to exercise that power depends on the ability to persuade. The Chairman of the Fed these days is not really an independent agent. Rather, he must be able to bring his colleagues along with his thinking while balancing pressures from the outside. In this sense, Mr. Greenspan has done an excellent job of navigating the political shoals of both the Administration and his own Open Market Committee.

The Greenspan Fed is open to criticism that it held rates too high too long and initiated this recent recession. Perhaps that's true. But the policy chosen by the Fed was a compromise with the zero-inflation faction that forms a sizable bloc within the Fed's decision process. This group would subordinate economic events to the goal of eliminating any increase in prices. Hence, the degree to which Greenspan could move against recession was limited strictly by his ability to pull the needed votes.

Similarly, the Fed has resisted the Administration's prodding to reinflate quickly to pull the economy out of recession. In part for political reasons, and in part because it has no other ideas, the Administration has leaned on the Fed to expand. We learned a long time ago that the short-term political benefit of pushing the inflation rate is not worth the long term economic pain. In remembering this, the Greenspan Fed has done us all yeoman service.

Unfortunately, this is perhaps the only positive economic news coming out of Washington as the President and the Congress seem hell bent on fixing what ain't broke and ignoring what is. And the long-term consequences of this short-term thinking will invariably be negative. In particular, the economic policy establishment seems hell-bent on meddling in the process by which the financial system is changing. But let's examine three areas.

1. *The Recession*. The recession of 1990-91 was, statistically, a mild one. In character, it was much like the slowdown of a decade ago, a wringing out of excesses -- inflation then, financial profligacy now. But this Administration hasn't used this correction to promote a growing future. Rather, like the residents of the Hotel California, they stabbed it with their steely knives, but could not kill the beast.

We live in an economy that has extinguished whole classes of jobs and awaits the generation of others. Yet, there is no movement to provide the incentives for investment that will create those jobs, no climate that will promote the modernization of our capital, no plan that will lead this economy into the world of the next decade. Simply returning the market to the tax regime that prevailed before August of 1986 would move us miles toward being a globally competitive market in the next century.

Contrast this with the rather clear direction set by public policy coming out of the 1980-82 recession. While you can in hindsight claim that policy ultimately set off forces we now regret, it was at least an active effort to move the economy.

2. *The Resolution Trust Corporation*. The process set up to untie the thrift snarl has become an institution that seems as short-term in nature as the National Archives. The goal of liquidating the assets of failed thrifts in a manner consistent with orderly markets and at maximum recovery to the government has been buried in some musty warehouse. RTC sales contracts run to 45 pages, and listings can be pulled at any time with no explanation or compensation.

For the seized institutions themselves, the process is no better. Congress, deathly afraid that someone, somewhere, is making a profit (what country did you say this was?) looks over every sale to ensure that the strictest possible terms are enforced. The net result is that not one penny of capital is likely to flow into the remains of the thrift industry, and the Congress will have finished off what it began with the Tax Reform Act of 1986.

Ultimately, the reluctance of the Congress to take bold actions and to trust the private sector will render the RTC a failure. Sports injuries occur most frequently to those who are least prepared to compete and most afraid of being hurt. As it stands now, we are setting ourselves up for a career-ending shot.

3. *Government-sponsored Enterprises*. One of the major reasons why the collapse of the thrift industry had little impact on residential mortgage finance was the presence of an active secondary market, led by Fannie Mae and Freddie Mac. Now the Treasury and the Congress, having "fixed" the failed thrift problems are attempting to "fix" the residential secondary market. Both seek to impose onerous capital standards on the secondary market agencies.

Are there problems in Fannie and Freddie? No. And perhaps that's the reason for the legislative blitzkrieg. In this age of failed thrifts, rocky commercial banks, and doubtful insurance companies, there is something unsettling about financial institutions that are profitable, well-managed and consumer beneficial. Sure sounds like a case for Congressional action. The capital standards now under consideration would most likely cost the consumer a percentage point on the mortgage rate, but it would produce a level playing field: Fannie and Freddie would be as badly off as the thrifts and banks.

This brings us full circle to the Fed. It has succeeded over a long period of time and under a variety of Chairs, because it does what it does and does it well. It has a long view, a fundamental trust of market capitalism and refuses to enter into fields where it is neither needed nor wanted. There has been a recent debate over whether the Fed should be subject to more control by the Congress and the Administration. I believe the terms of the debate, in the national interest, ought to be reversed.

Outlook for the Economy

The economy's forward progress in the spring gave the impression that the recovery was building up a powerful head of steam. But many recent statistics suggest that we may have only witnessed a train rolling along a downgrade, with little real power of its own. Job growth was negative in July, and orders for durable goods fell sharply in June. Once the momentum from the spurt of activity following the Gulf War is spent, we may find that our economic locomotive is actually sputtering, not steaming ahead.

While the economic fundamentals still remain weak, several factors nevertheless continue to suggest recovery. Businesses are expanding production in order to restock the inventories depleted in the first half of the year. The engineers at the Federal Reserve eased monetary policy in early August, with an eye toward promoting additional growth. After declining impressively in the first half of August, long-term interest rates are expected to fall a bit further as positive inflation reports continue to roll in (see chart). Taken together, these factors suggest that the recovery will be able to motor along and avoid the much-discussed double dip of recession. A 2.4% growth rate is projected for the third quarter, and growth over the next four quarters is expected to average 2.9%, which is low for a recovery. Compared to a meager 1.0% rise in 1990, real GNP, as measured on a year-over-year basis, is projected to drop 0.2% in 1991 before gaining 2.9% in 1992.

Consumers Lead Second-Quarter Rebound

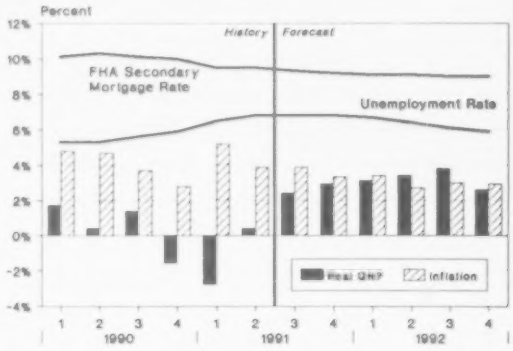
A springtime spurt in consumer spending helped the economy reverse its decline and post a small 0.4% annual rate of increase in the second quarter. Expenditures on autos rose sharply, and overall consumer spending rose 3.6% after falling at a 2.5% rate in the previous six months. In fact, consumer spending seemed especially healthy since its growth rate in the second quarter was three times the rate recorded during 1989, the last full year of expansion.

But it's important to note that consumer spending usually does much better as the economy comes out of a recession. During the next twelve months, growth in consumption will be only half of the 5.0% increase recorded in the year following the 1981-82 recession. The slow pace is due to the soft gains in employment and income that are expected.

Rebuilding Inventories Should Boost Growth

Because a significant portion of the goods consumers loaded into their shopping baskets during the second quarter came out of inventories, not current production, the level of inventories fell (see chart). By another measure, which computes the ratio of total inventories to the total sales rate, inventories remain well in control; according to the most recent data, the ratio fell sharply from March to May. With almost $73 billion of stock liquidated in the past nine months, businesses are likely to build up inventories to more normal levels in the third quarter. Although inventories are expected to drop again by less than $3 billion in the second quarter, the lower rate of reduction is expected to be an important contributor to growth in the third quarter. In fact, about three-quarters of the quarter's projected 2.4%

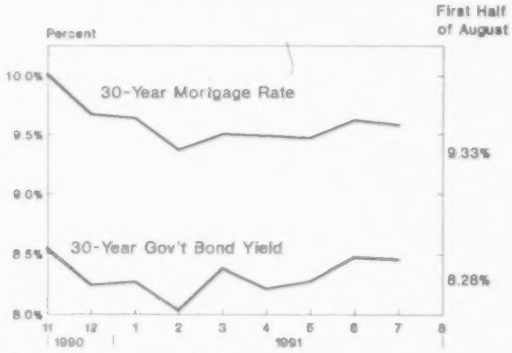
The Economic Outlook



Sources: BEA, BLS, FHLMC, NAR forecast

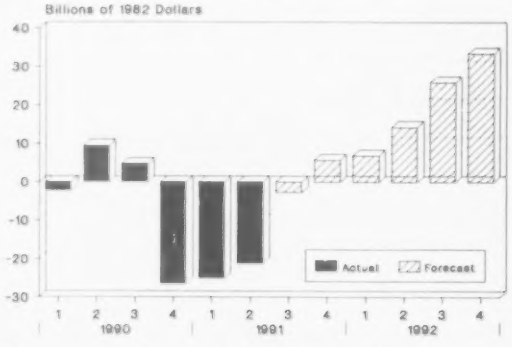
Long-Term Rates Fall in August

Mortgage Rates at Their Lowest Since February



Source: Federal Reserve Board

Inventory Liquidation in First Half Sets Stage for Growth



Source: Bureau of Economic Analysis; NAR forecast

growth rate can be attributed to a sharply slower rate of inventory reduction.

Will Consumers Remain at the Party?

Sluggish growth in consumer spending would provide business with some unwanted help in its goal of replenishing stockpiles. If industry overshoots in its production schedules in the third quarter (consequently building up inventories too fast), then a correction in the fourth quarter would dampen the youthful recovery. With both consumers and businesses cutting back, and governments at all levels restricted by their own fiscal squeeze, then it's possible that the economy could slip back into recession.

What makes such a double-dip scenario plausible is the way that the growth in personal income has lagged the growth in consumer spending (see chart). In the second quarter, spending rose 3.6% while income was up only 1.1%, after accounting for inflation and taxes. As a consequence, the personal saving rate slipped to 3.7% from 4.2% the quarter before. With income growth lagging and the saving rate dropping, the fundamental supports to consumer spending appear weak.

Long-Term Rates Drop After Fed Eases

Citing an uneven and fragile recovery, the Federal Reserve purchased some insurance against slipping back into recession by lowering their target on the federal funds rate, a key short-term interest rate. The Fed had been reluctant to ease monetary policy further for fear of fanning any inflationary flames that may result from the recovery. The Fed's governors are also cognizant that the current period -- the transition between recession to recovery -- has been the most perilous for monetary policy. Often the Fed has overstimulated a budding recovery with the result that the extra (and, in hindsight, unnecessary) nudge to growth turned into additional inflation.

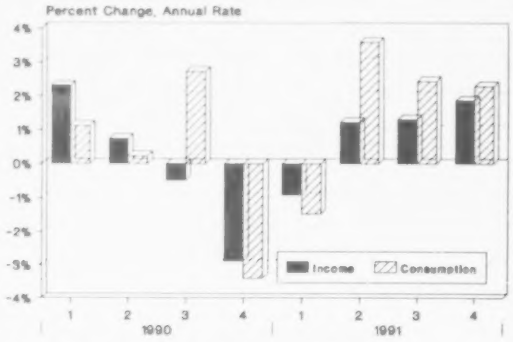
On the other hand, besides the other signs of weakness, the growth in the nation's money supply had slipped to the low end of the Fed's target in the past few months, as shown at right. This was of concern, since falling money supply growth could be a precursor of slower economic activity. With inflation apparently in check (see chart), the Fed thought it had both the reason and the room to ease.

One hurdle keeping the recovery from being robust is the high long-term interest rates, and the Fed's move might have sent them higher. These rates would have crept up if the market had thought that the move was unwarranted -- meaning that the Fed didn't buy extra real growth, just more inflation. The financial markets apparently thought that the move was appropriate, however, for rates fell. Within two weeks, the yield on 30-year government bonds dropped from 8.4% to 8.2%, and 30-year mortgage rates fell from 9.5% to 9.3%. This implies that the market accepted the Fed's view that the economy needed help, and that the help, in the form of looser monetary policy, would be noninflationary.

As it is, inflation continues as the bright spot in the economy. The Consumer Price Index, for example, is expected to fall by about a percentage point a year in the next two years -- from 5.4% in 1990 to 4.3% in 1991 and then to 3.5% in 1992.

Spending Outpaces Income

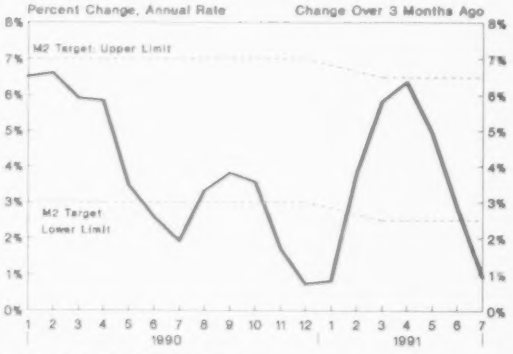
Real Disposable Income & Consumer Expenditures



Source: Bureau of Economic Analysis; NAR forecast

Money Growth Sharply Lower

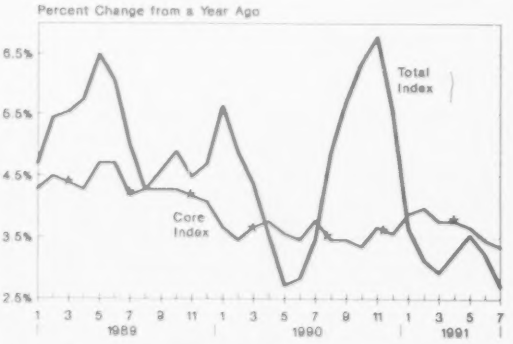
M2 Slips Below the Lower Bound of Its Target



Source: Federal Reserve Board

Producer Prices Show Restraint

Less Food & Energy, Index Decelerates to 3.5%



Source: Bureau of Labor Statistics

Housing Starts

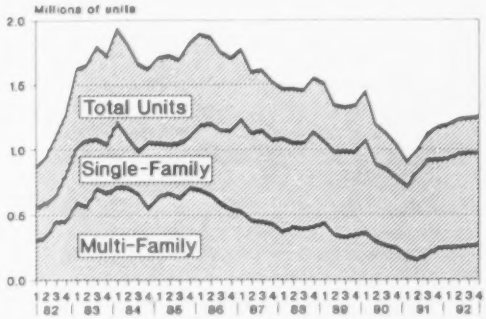
National Data

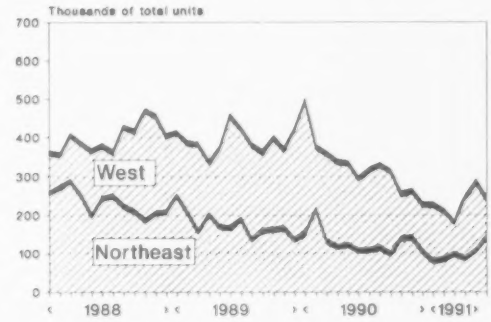
	Total	SF	MF:2-4	MF:5+
Jun 1990	1,187	890	41	256
Jan 1991	847	648	29	170
Feb 1991	992	788	37	167
Mar 1991	907	742	28	137
Apr 1991	977	801	32	144
May 1991	989	836	32	121
Jun 1991	***1,040***	***868***	***30***	***142***
Annual Averages:				
1989	1,376	1,003	55	318
1990	1,193	895	38	260
Percent Changes in June 1991 since:				
Jun 1990	-12.4	-2.5	-26.8	-44.5
May 1991	5.2	3.8	-6.3	17.4

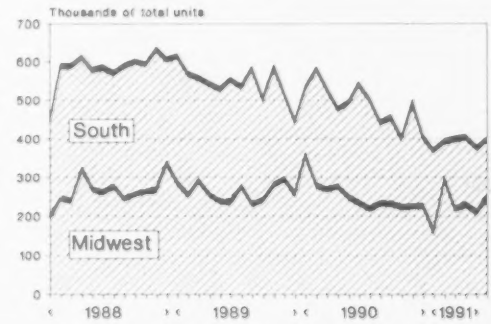
Regional Data

	Northeast	Midwest	South	West
Jun 1990	114	241	532	300
Jan 1991	86	167	361	233
Feb 1991	91	301	384	216
Mar 1991	104	226	390	187
Apr 1991	93	236	395	253
May 1991	114	217	367	291
Jun 1991	***148***	***255***	***389***	***248***
Annual Averages:				
1989	179	266	536	396
1990	131	253	479	329
Percent Changes in June 1991 since:				
Jun 1990	29.8	5.8	-26.9	-17.3
May 1991	29.8	17.5	6.0	-14.8

Levels are seasonally adjusted annual rates, in thousands.
Source: Bureau of the Census, Construction Reports, Series C25







Housing starts surpassed the 1 million mark in June, increasing 5.2% from May's rate of 989,000 units. After increasing in each of the last three months, second quarter starts posted a healthy 9.5% gain over the first quarter's rate.

June's performance is further evidence that housing markets are regaining strength. The construction of multifamily homes with 5 or more units surged 17.4% to 142,000 units. However, a 6.3% decline in the construction of multifamily homes with 2 to 4 units tempered these gains. Overall, multifamily starts increased 12.4%. Advances were also made in the construction of single-family homes, with starts increasing 3.8% to a rate of 868,000 units.

Building activity in the Northeast accounted for much of the increase in June. After rising 22.6% in May, starts increased another 29.8% in June, bringing the annual rate to 148,000 units. The Midwest also posted a hefty gain. There, starts increased 17.5% to 255,000 units. In the South, starts increased 6.0% to 389,000 units, while a decline of 14.8% in the West brought the rate of starts down to 248,000 units.

According to the NAR forecast, housing starts will increase 12.9% during the third quarter of this year. Single-family starts will account for 72% of the total gain. Fueled by lower mortgage rates and a looser lending environment in 1992, total starts are expected to post a healthy 17.1% gain over 1991. This improved environment is expected to boost the multifamily construction market, with multifamily starts forecast to increase 32.6% in 1992. The single-family construction market will benefit as well, with starts increasing 13.4%.

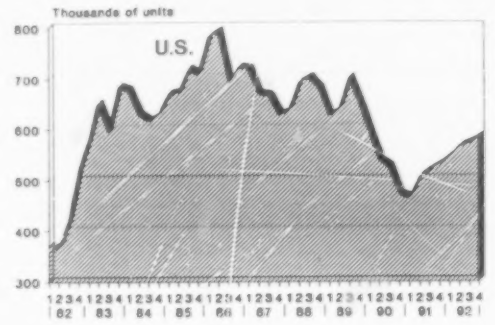
National Data

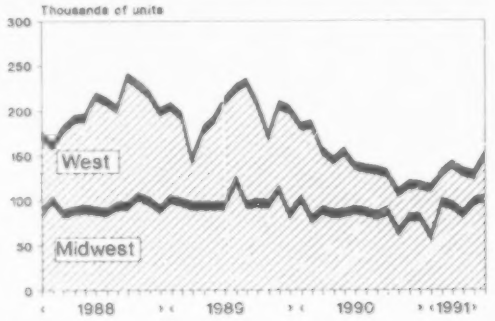
		Mo. Ago % Chg.	Yr. Ago % Chg.
Jun 1990	549	2.8	-15.0
Jul 1990	541	-1.5	-27.0
Aug 1990	525	-3.0	-27.0
Sep 1990	504	-4.0	-21.0
Oct 1990	465	-7.7	-26.9
Nov 1990	480	3.2	-30.1
Dec 1990	464	-3.3	-26.7
Jan 1991	414	-10.8	-34.0
Feb 1991	488	17.9	-19.5
Mar 1991	495	1.4	-11.4
Apr 1991	505	2.0	-5.4
May 1991	489	-3.2	-8.4
Jun 1991	***525***	***7.4***	***-4.4***
Annual Averages:			
1989	650		-3.7
1990	534		-17.8

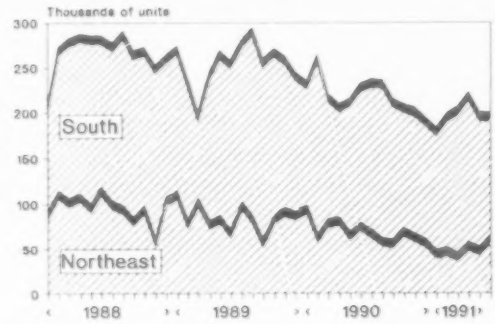
Regional Data

	Northeast	Midwest	South	West
Jun 1990	80	94	232	143
Jan 1991	49	65	183	118
Feb 1991	52	102	199	134
Mar 1991	46	99	206	144
Apr 1991	58	90	222	136
May 1991	53	103	200	133
Jun 1991	***66***	***106***	***199***	***153***
Annual Averages:				
1989	86	102	260	202
1990	71	89	225	149
Percent Changes in June 1991 since:				
Jun 1990	-17.5	12.8	-14.2	7.0
May 1991	24.5	2.9	-0.5	15.0

Levels are seasonally adjusted annual rates, in thousands.
Source: Bureau of the Census, Construction Reports, Series C25







After a downturn in May, the new home sales rate increased 7.4% in June, climbing to the half-million mark. Despite the increase, sales remain 4.4% below one year ago, and, measured on a year-to-date basis, 14.4% below the first half of 1990.

Sales activity in the four Census reporting regions varied in June. In the Northeast, where the recession has taken the heaviest toll, new home sales increased a surprising 24.5% to an annual rate of 66,000 units. New home sales were also strong in the West. There, sales reached their highest level since March of 1990, increasing 15% to an annual rate of 153,000 units. In the Midwest, the pace of new home sales edged up only 2.9% to an annual rate of 106,000 units. The South was the only region to see a decline in new home sales in June. In that region, the pace of new home sales deteriorated 0.5% to an annual rate of 199,000 units.

As the economy recovers and mortgage rates continue to fall, the demand for new homes is expected to grow. According to the NAR forecast, the rate of new home sales is projected to increase 2.4% and 2.3% during the third and fourth quarters of 1991, respectively. In the first half of 1992, the pace of new home sales is expected to accelerate, with increases of 3% and 3.5% in the first and second quarters of 1992, respectively. For the remainder of 1992, new home sales will continue to increase, but at a slower pace. For all of 1992, new home sales are projected to post a 12.3% gain over 1991.

Lower mortgage rates will continue to stimulate new home sales into 1993. Overall, the rate of new home sales is forecast to increase 7.4% to an annual rate of 609,000 units in 1993.

Existing Home Sales

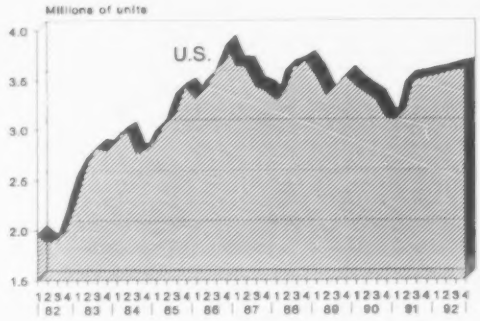
National Data

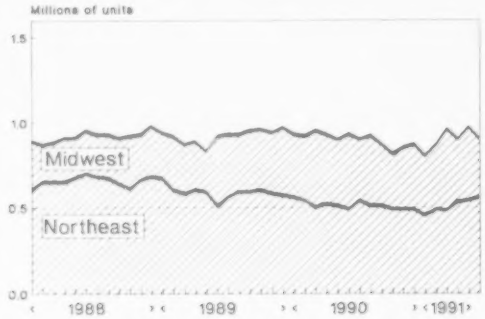
		Mo. Ago % Chg.	Yr. Ago % Chg.
Jun 1990	3,370	0.6	1.2
Jul 1990	3,320	-1.5	1.2
Aug 1990	3,410	2.7	-1.8
Sep 1990	3,160	-7.3	-0.9
Oct 1990	3,070	-2.8	-10.0
Nov 1990	3,150	2.6	-12.0
Dec 1990	3,130	-0.6	-11.5
Jan 1991	2,900	-7.3	-12.1
Feb 1991	3,160	9.0	-16.4
Mar 1991	3,220	1.9	-7.6
Apr 1991	3,310	2.8	-6.4
May 1991	3,540	6.9	-1.8
Jun 1991	***3,590***	***1.4***	*5.7*
Annual Averages:			
1989	3,440		-4.3
1990	3,296		-4.2

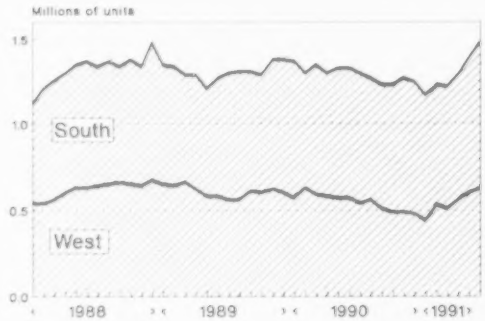
Regional Data

	Northeast	Midwest	South	West
Jun 1990	500	940	1,340	580
Jan 1991	460	810	1,180	450
Feb 1991	500	880	1,240	540
Mar 1991	490	970	1,230	520
Apr 1991	540	910	1,300	570
May 1991	550	980	1,400	610
Jun 1991	***570***	***910***	***1,490***	***630***
Annual Averages:				
1989	589	919	1,307	610
1990	522	892	1,325	557
Percent changes in June 1991 since:				
Jun 1990	14.0	-3.2	11.2	8.6
May 1991	3.6	-7.1	6.4	3.3

Levels are seasonally adjusted annual rates, in thousands.
Source: National Association of Realtors, 'Home Sales'







The rate of existing home sales continued its ascent in June. After increasing 6.9% in May, the resale rate grew another 1.4% in June to 3.59 million units. June's figure is the highest rate since January of 1989, and increases in April, May and June translate into a gain of 12.5% over the first quarter of this year.

Of the four Census reporting regions, the Midwest was the only region that did not post a gain in resales during June. There, sales fell 7.1% to an annual rate of 910,000 units.

Each of the remaining regions saw increases in existing home sales in June. In the South, existing home sales increased 6.4% from May's rate of 1.5 million units. Sales of existing homes increased 3.6% in the Northeast to a rate of 570,000 units. Similarly, the West saw an increase of 3.3%, rising to an annual rate of 630,000 units. In each of the regions experiencing increases, the resale rate is above its year-ago figure.

The outlook for existing home sales is optimistic. While the strong gains in the second quarter are probably a reaction to the end of the uncertainty surrounding the Persian Gulf war and thus unsustainable, by year end sales are expected to post a 13.9% gain over the first quarter's rate. This translates into a gain of 429,000 units. For the year as a whole, sales are expected to increase 3.1% in 1991.

The momentum established in 1991 will position the resale market for stable growth in 1992 and 1993. In 1992, sales are projected to increase 5.3% to an annual rate of 3.58 million units. In 1993, the rate of existing home sales will continue to increase, but at the slower pace of 2.4%.

National Data

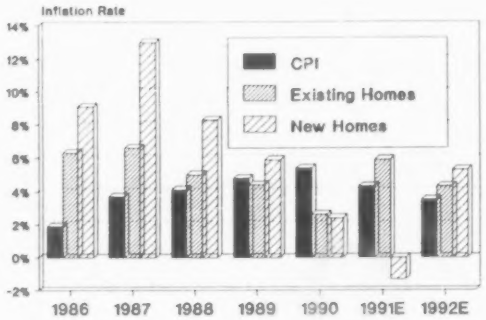
	Median		Average	
	Existing	New	Existing	New
Jun 1990	98,900	125,000	122,500	150,400
Jan 1991	95,600	117,900	123,000	148,600
Feb 1991	94,000	119,900	119,700	147,800
Mar 1991	98,200	122,500	125,200	156,400
Apr 1991	100,300	120,700	128,900	150,000
May 1991	101,100	117,100	130,600	149,700
Jun 1991	***101,900***	***120,000***	***130,300***	***148,500***
Annual Averages:				
1989	93,100	120,400	118,100	148,300
1990	95,500	122,300	118,600	149,100
Percent changes in June 1991 since:				
Jun 1990	3.0	-4.0	6.4	-1.3
May 1991	0.8	2.5	-0.2	-0.8

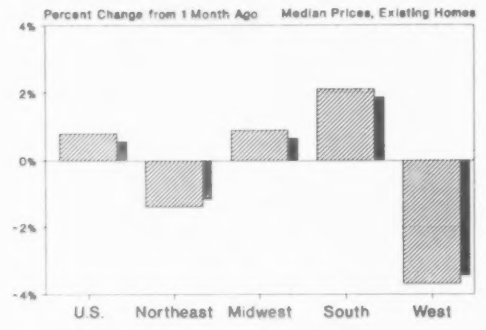
Regional Data

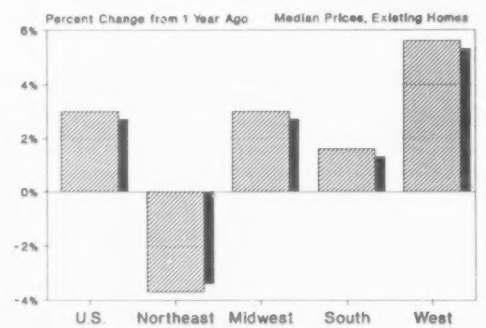
Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
Jun 1990	148,300	75,900	89,400	138,700
Jan 1991	136,900	74,500	84,600	149,600
Feb 1991	137,200	76,400	83,200	137,100
Mar 1991	142,700	78,200	87,300	147,300
Apr 1991	144,800	77,900	88,000	151,800
May 1991	144,900	77,500	88,900	152,100
Jun 1991	***142,800***	***78,200***	***90,800***	***146,400***
Annual Averages:				
1989	145,200	71,300	84,500	139,900
1990	141,200	74,000	85,900	139,600
Percent changes in June 1991 since:				
Jun 1990	-3.7	3.0	1.6	5.6
May 1991	-1.4	0.9	2.1	-3.7

Levels are shown in dollars.
Source: National Association of Realtors, 'Home Sales'







For the fourth consecutive month, the median price of existing single-family homes rose in June. The median price followed May's 0.8% increase with another 0.8% gain in June to stand at $101,900. Over the past twelve months, the median price has risen 3.0%. Home sellers are benefiting from lower interest rates, which have generated more buying activity and have lessened pressure on sellers to lower prices. Although mortgage rates have risen slightly from their mid-winter lows, they remain low relative to rates a year ago.

Meanwhile, in the market for new homes, the median price partially reversed May's 3.0% decline with a 2.5% increase in June. It now stands at $120,000, down 4.0% from the median price one year ago.

The average price of an existing home deteriorated 0.2% in June to $130,300. When compared with June of 1990, the average price has risen 6.4%.

For the remainder of 1991, the median price of existing homes is expected to appreciate modestly. An overall increase of 5.9% in 1991 will hold the median price at the $100,000 mark. In 1992 and 1993, the median price will continue to appreciate, increasing 4.3% and 4.4%, respectively. The median price of new single-family homes is expected to fall 1.3% in 1991. By 1992, however, prices are expected to appreciate with renewed force, and the median price is projected to increase 5.3% to $127,100.

Robert D. Barr
Director of Forecasting

Kimberly A. Martin
Research Economist

Forecasting & Policy Analysis

These historical tables are featured
in the February, May, August and November
issues of the Real Estate Outlook.

Economic Indicators

	GNP	CPI	Unemployment Rate	Mortgage Rate	Short-Term Rate	Long-Term Rate
	Percent Change	*Percent Change*	*Percent*	*Percent*	*Percent*	*Percent*
Annual						
1980	-0.2	13.5	7.2	13.8	11.4	11.3
1981	1.9	10.4	5.8	10.6	9.4	9.0
1982	-2.5	6.2	6.4	12.9	11.1	10.3
1983	3.6	3.2	9.6	13.2	8.6	11.2
1984	6.8	4.4	7.5	13.9	9.5	12.4
1985	3.4	3.5	7.2	12.4	7.5	10.8
1986	2.7	1.9	7.0	10.2	6.0	7.8
1987	3.4	3.7	6.2	10.2	5.8	8.6
1988	4.5	4.1	5.5	10.3	6.7	9.0
1989	2.5	4.8	5.3	10.3	8.1	8.4
1990	1.0	5.4	5.5	10.1	7.5	8.6
Quarterly						
1984:1	10.7	5.8	7.9	13.3	9.2	12.0
2	5.5	3.8	7.4	14.0	9.8	13.2
3	2.6	3.5	7.4	14.5	10.3	12.7
4	1.7	3.5	7.3	13.7	8.8	11.7
1985:1	4.9	3.7	7.2	13.1	8.2	11.6
2	2.4	3.7	7.3	12.8	7.5	11.0
3	4.1	2.5	7.2	12.1	7.1	10.6
4	3.0	4.1	7.0	11.7	7.2	10.0
1986:1	6.6	2.1	7.0	10.6	6.9	8.8
2	-1.8	-1.9	7.2	10.3	6.1	7.5
3	0.8	2.5	7.0	10.2	5.5	7.4
4	2.3	2.8	6.8	9.7	5.4	7.5
1987:1	5.2	5.4	6.6	9.1	5.5	7.5
2	4.2	4.6	6.3	10.3	5.7	8.5
3	4.1	4.1	6.0	10.5	6.0	9.1
4	6.6	3.8	5.8	10.9	5.9	9.2
1988:1	5.1	3.2	5.7	10.1	5.7	8.6
2	3.6	4.7	5.5	10.4	6.2	9.1
3	2.7	5.2	5.5	10.5	7.0	9.2
4	2.7	4.3	5.3	10.4	7.7	9.0
1989:1	3.6	5.0	5.2	10.8	8.5	9.0
2	1.6	6.2	5.3	10.7	8.4	8.7
3	1.7	3.2	5.3	10.0	7.8	8.1
4	0.3	4.0	5.3	9.8	7.7	7.9
1990:1	1.7	7.4	5.3	10.1	7.8	8.4
2	0.4	3.9	5.3	10.3	7.7	8.7
3	1.4	6.9	5.6	10.1	7.5	8.8
4	-1.6	7.0	5.9	10.0	7.0	8.5
1991:1	-2.8	3.5	6.5	9.5	6.0	8.2
2	0.4	2.1	6.8	9.5	5.6	8.3

Note: Quarterly levels and percentages are annualized. Quarterly figures may not average to annual figures due to rounding. The 3-Month Treasury Bill is shown as "Short-Term Rate"; The 30-Year Treasury Bond is shown as "Long-Term Rate."

Housing Starts

Thousands of Units, Seasonally Adjusted; Percent Change

	Total		Single-Family		Multi-Family	
Annual						
1980	1,300	-24.3	855	-27.0	445	-18.4
1981	1,096	-15.7	711	-16.9	386	-13.4
1982	1,057	-3.6	663	-6.7	394	2.3
1983	1,705	61.3	1,065	60.6	641	62.4
1984	1,768	3.7	1,098	3.1	669	4.5
1985	1,741	-1.5	1,071	-2.5	671	0.2
1986	1,812	4.0	1,182	10.4	630	-6.1
1987	1,631	-10.0	1,154	-2.4	476	-24.3
1988	1,488	-8.7	1,083	-6.2	405	-15.0
1989	1,376	-7.5	1,003	-7.4	373	-7.9
1990	1,193	-13.3	895	-10.8	298	-20.1
Quarterly						
1984:1	1,940	12.2	1,221	16.0	719	6.3
2	1,829	-5.7	1,103	-9.6	726	1.0
3	1,671	-8.7	1,004	-9.0	667	-8.1
4	1,630	-2.4	1,066	6.2	565	-15.4
1985:1	1,714	5.2	1,064	-0.2	650	15.2
2	1,726	0.7	1,053	-1.0	673	3.4
3	1,701	-1.4	1,059	0.6	642	-4.6
4	1,825	7.3	1,108	4.6	717	11.7
1986:1	1,899	4.1	1,198	8.1	701	-2.2
2	1,878	-1.1	1,215	1.5	663	-5.5
3	1,759	-6.4	1,161	-4.4	597	-9.9
4	1,712	-2.6	1,155	-0.5	557	-6.8
1987:1	1,761	2.9	1,237	7.1	524	-5.9
2	1,612	-8.5	1,138	-8.0	474	-9.6
3	1,625	0.8	1,163	2.2	462	-2.5
4	1,524	-6.2	1,079	-7.3	445	-3.7
1988:1	1,425	-6.5	1,057	-2.0	368	-17.2
2	1,491	4.6	1,066	0.9	425	15.3
3	1,484	-0.4	1,071	0.5	413	-2.8
4	1,551	4.5	1,137	6.1	414	0.4
1989:1	1,464	-5.6	1,026	-9.8	438	5.8
2	1,360	-7.1	999	-2.7	362	-17.5
3	1,348	-0.9	1,003	0.4	346	-4.4
4	1,352	0.2	994	-0.9	358	3.5
1990:1	1,433	6.0	1,064	7.1	369	3.2
2	1,204	-16.0	896	-15.8	308	-16.5
3	1,131	-6.1	856	-4.4	274	-10.9
4	1,042	-7.8	786	-8.2	256	-6.7
1991:1	915	-12.2	726	-7.7	189	-26.0
2	1,002	9.5	835	15.0	167	-11.8

Note: Quarterly levels are annualized. Simple percent changes are shown.
Quarterly figures may not average to annual figures due to rounding.

Housing Starts by Region

Thousands of Units, Seasonally Adjusted; Percent Change

	Northeast		Midwest		South		West	
Annual								
1980	125	-30.9	218	-34.0	647	-12.6	309	-33.4
1981	117	-6.5	175	-19.7	565	-12.7	239	-22.8
1982	113	-3.2	142	-18.8	596	5.4	206	-13.7
1983	171	50.8	217	52.8	937	57.3	380	84.5
1984	207	20.7	247	13.6	873	-6.8	440	15.7
1985	249	20.8	237	-4.0	785	-10.1	470	6.8
1986	298	19.5	298	25.8	732	-6.8	484	3.0
1987	269	-9.7	308	3.3	633	-13.5	420	-13.1
1988	239	-11.4	272	-11.9	574	-9.3	404	-3.9
1989	179	-24.9	266	-2.1	536	-6.6	396	-2.0
1990	131	-26.8	253	-4.9	479	-10.6	329	-16.9
Quarterly								
1984:1	201	29.4	269	29.1	976	0.8	494	24.2
2	197	-1.8	252	-6.2	922	-5.5	451	-8.7
3	195	-1.4	233	-7.7	825	-10.6	420	-6.9
4	233	19.7	234	0.3	768	-6.8	395	-5.8
1985:1	228	-2.3	222	-4.9	790	2.8	474	20.0
2	260	14.3	243	9.1	765	-3.1	457	-3.6
3	230	-11.7	236	-2.9	755	-1.4	481	5.1
4	280	21.6	248	5.2	830	10.0	467	-2.8
1986:1	315	12.6	294	18.5	809	-2.5	481	2.9
2	290	-7.9	298	1.5	776	-4.1	514	6.9
3	299	3.1	302	1.1	706	-9.0	452	-12.0
4	288	-3.7	300	-0.7	636	-9.9	489	8.1
1987:1	285	-0.9	372	24.1	633	-0.5	471	-3.5
2	273	-4.3	296	-20.3	631	-0.3	412	-12.7
3	265	-3.1	281	-5.1	658	4.3	421	2.3
4	254	-4.2	283	0.7	609	-7.4	377	-10.4
1988:1	278	9.7	235	-17.1	532	-12.6	380	0.6
2	236	-15.1	290	23.4	583	9.5	382	0.5
3	234	-1.1	266	-8.4	578	-0.9	407	6.6
4	206	-12.0	296	11.3	602	4.2	448	10.1
1989:1	211	2.4	283	-4.2	571	-5.1	399	-10.9
2	185	-12.2	250	-11.8	532	-6.8	393	-1.5
3	168	-9.4	256	2.5	531	-0.3	393	0.1
4	161	-4.2	284	10.9	506	-4.7	401	1.9
1990:1	172	7.3	308	8.4	538	6.3	415	3.5
2	122	-29.2	260	-15.8	495	-8.0	327	-21.1
3	114	-6.8	235	-9.5	457	-7.7	325	-0.7
4	134	17.6	232	-1.4	423	-7.4	254	-21.9
1991:1	94	-29.9	231	-0.1	378	-10.6	212	-16.4
2	118	26.3	236	2.0	384	1.4	264	24.5

Note: Quarterly levels are annualized. Simple percent changes are shown.
Quarterly figures may not average to annual figures due to rounding.